# Does a Contractual Liability Exclusion in Professional Liability Policies Render Coverage Illusory?

**By**

**Robert M. Hall**

*Mr. Hall is an attorney, a former law firm partner, a former insurance and reinsurance executive and acts as an insurance and reinsurance consultant as well as an arbitrator of insurance and reinsurance disputes and as an expert witness. He is a veteran of over 200 arbitration panels and is certified as an arbitrator and umpire by ARIAS - US. The views expressed in this article are those of the author and do not reflect the views of his clients.*

*Mr. Hall has authored over 100 articles and they may be viewed at his website:robertmhalladr.com.*

## I. Introduction

Professional liability policies, as well as others, commonly contain a provision excluding coverage for claims based upon or arising out of a breach of a policy or other contract. If applied literally, this could significantly reduce coverage of claims with a contract in the fact pattern *i.e.* a professional liability policy covering an insurer's claim handling under its policies and an allegation of failure to properly settle a claim. The courts have taken several approaches to this issue and selected case law on point is summarized below.

## II. Contractual Exclusion Makes Coverage Illusory

An emerging argument on point is demonstrated by the recent case of *Crum & Forster Specialty Ins. Co. v. DVO, Inc.,* 2019 U.S. App. LEXIS 28714 (7th Cir.). Crum & Forster insured DVO under a professional liability policy that stated that it shall not cover any claim or suit:

> Based upon or arising out of: a breach of contract, whether express or oral, nor any claim for breach of an implied in law or an implied in fact contracts [sic], regardless of whether bodily injury, property damage, personal and advertising injury or a wrongful act is alleged.[1]

DVO contracted to provide a certain product to its client but the client sued alleging that DVO failed to fulfill its contractual design duties and responsibilities. Crum & Forster denied professional liability coverage based on the above contractual exclusion.

The court defined the issue as follows:

> The sole issue, then, is whether the language in that breach of contract exclusion renders the exclusion broader than the grant of coverage and therefore renders the coverage illusory. "In the insurance context, '[i]llusory policy language defines coverage in a manner that coverage will never actually be triggered." If the purported coverage in a policy proves to be illusory, a court may reform the policy to meet the insured's reasonable expectation of coverage.[2]

Given the broad sweep of the "arising out of" policy language, the court found that this language would exclude the claims of third parties with any relation to contracts and, therefore, was illusory. The court remanded the matter back to the district court to reform the policy to meet DVO's reasonable expectations of coverage.

Since this is a very recent case, it has yet to create a precedential following but there are prior cases on point that present different views of this subject.

## III. Case Law Not Limiting Exclusion to Torts of Third Parties

Some courts have given sweeping effect to the contractual exclusion applying it to any claims related to a contact. *Spirtas Co v. Federal Ins. Co.,* 521 F.3d 833 (8th Cir. 2008) deals with a Directors' and Officers' claim under a demolition contract. Interpreting Missouri law, the court ruled that the contractual exclusion applies liability related to contracts:

> [T]he term "arising from" is construed broadly such that an exclusion precluding insurance coverage for claims arising from a contract not only applies to claims sounding directly in contract but also to claims sounding in tort as long as they "flowed from or had their origins in the breach of the [] contract. . . ."
>
> In this case, the five counts [underlying plaintiff] alleged in its lawsuit against [defendant] all arose from the contractual relationship between the parties and flowed from [underlying defendant's] alleged breach of the subcontract, and thus the D & O policies' contract exclusions applied notwithstanding the fact some of [underlying plaintiff's] counts sounded in tort rather than in contract.[3]

*MarineMax, Inc. v. National Union Fire Ins. Co.,* 2013 U.S. Dist. LEXIS (M.D.FL) involved a professional liability policy which included an exclusion for "liability you assume under any contract or agreement, including but not limited to, any contract price, cost guarantee or cost

estimate being exceeded; . . ."[4] The insured brokered loans to banks which sued the insured alleging breach of contract and negligence in placing the loans with the banks. The insured, argued that the exclusion pertained only to the liability of third parties but the court held otherwise:

> [T]he Court cannot agree with [the insured's] contention. The exclusion does not contain any language limiting it to only *tort* liability that [the insured] has assumed in a contract. Furthermore, the provision expressly states that liability for "any contract price, cost guarantee or cost estimate being exceeded" is excluded; thus the Court agrees with [the insurer] that the exclusion "contemplates contract obligations of the insured and is not limited to indemnification contracts of third parties."[5]

*See also, W.G. Hall, LCC v. Zurich Am. Ins. Co.,* 2017 U.S. Dist. LEXIS 141389 (N.D.CA).

**IV. Case Law Limiting Exclusion to Torts of Third Parties**

The application of a professional liability policy to loan commitments by a finance company was the backdrop to *Cincinnati Ins. Co. v. Stonebridge Fin. Corp.,* 797 F. Supp.2d 534 (E.D. PA. 2011). The finance company failed to provide financing on a project and was sued for breach of contract and promissory estoppel. The insurer denied the claim on the basis that it arose out of an excluded contract. The court rejected this argument ruling:

> [C]ourts have consistently interpreted the contractual liability exclusion at issue here – a preclusion of coverage for "liability assumed under contract" – to apply only to instances where the insured agrees to "assume" the tort liability of a third party, such as an indemnification and hold harmless agreements. . . .
>
> We find this interpretation compelling particularly in the context of an E & O policy designed to insure against the special risks inherent in the lending business. Here, the Policy not only insures errors, omissions, or acts committed by [the insured] in the performance of *professional services* – defined to encompass all of [the insured's] activities on behalf of its clients – but is also specifically covers "claims arising out of any 'wrongful lending act' related to an extension of credit or refused extension of credit to a borrower."[6]

*Idaho Trust Bank v. BancInsure, Inc.* 2014 U.S. Dist. LEXIS 37660 (D. ID) involved a professional liability policy issued to a bank. The bank was sued for failure to provide alleged promised financing and the insurer denied the claim as arising from a financing contract. The court found for the bank ruling:

> An insurer cannot seek to apply policy limitations and exclusions in a way to defeat the precise purpose for which the insurance is purchased. While the court does not find the contractual liability exclusion to render the Policy completely illusory, the Court will not enforce it against [the insured] on the particular facts in this case. Again, the Court emphasizes that an insurer cannot in one section provide coverage for acts that include "an actual or alleged agreement" and then, in another section, attempt to exclude coverage for claims "based upon [or] arising out of" the failure to perform any contract or agreement."[7]

Various false advertising and misrepresentations claims were made against the insured in *Ironshore Specialty Ins. Co. v. 23andMe, Inc.*, 2016 U.S. Dist. LEXIS 96079 (N.D. CA). The insurer alleged that all of the relevant claims related to contacts and were thereby excluded. Interpreting California law, the district court opined that a California court would adopt what it characterized as the majority view *i.e.* that contractual liability exclusions are limited to assuming the liability of third parties.[8] Since the insurer argued that all the claims at issue related to contracts, the court ruled that the insurer's "construction of the exclusion would appear to defeat the professional liability coverage for which [the insured] bargained."[9]

## V. Case Law Finding the Contractual Liability Exclusion Ambiguous

In *Tankovits v. Del Suppo, Inc.,* 129 Fed. Appx. 829 (4th Cir. 2005) the court found the language and structure of the policy including professional liability coverage to be ambiguous. Therefore, under Pennsylvania law, the court was required to construe the language of the policy against the drafter and in favor of the insured.[10]

## VI. Commentary

Clearly, case law is very mixed on the issue of the contractual exclusion common in professional liability policies. Perhaps the "illusory contact" case summarized in § 2, *supra*, is a waypoint to the case law in § 4 interpreting the exclusion to apply to assumption of the liability of third parties rather than to any claim related to a contract.

It is curious that in none of the cases cited above was expert testimony cited to illuminate the meaning of the exclusion. Speaking as a drafter of quite a few professional liability policies, it is likely that such testimony would support the conclusions reached in the cases in § 4, *supra.*

**Endnotes**

[1] 2019 U.S. App. LEXIS *5 – 6.
[2] *Id.* at *7 (internal citations omitted).
[3] 521 F. 3d 833 at 835 – 6 (internal citations omitted).
[4] 2013 U.S. Dist. LEXIS *24.
[5] *Id.* (internal citations omitted).
[6] 797 F. Supp. 2d at 540. (internal citations omitted).
[7] 2014 U.S. Dist. LEXIS *35 (internal citations omitted).
[8] 2016 U.S. Dist. LEXIS 96079 *15 – 16.
[9] *Id.* at *20 – 21.
[10] 129 Fed. Appx. at 837.